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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 269

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERITE SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO.; *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

We respectfully submit that the respondent's brief in opposition has not diminished the need for certiorari here. Indeed, it amply confirms our view that this case merits the thoughtful consideration of this Court.

1. Nothing in the respondent's brief dispels the conflict in appellate decisions as summarized by the petitioners. (Pet. 15-20.) In fact, the respondent admits that in *Rowan* v. *United States*, 219 F. 2d 51 (5th Cir.

1955), and *Sun Properties* v. *United States*, 220 F. 2d 171 (5th Cir. 1955), the Fifth Circuit "criticizes the Commissioner's reliance on 'thin capitalization.'" (Resp. 7.)[1] As so expressed, the respondent's concession is an undue understatement. The so-called "criticisms" by the Fifth Circuit are unmistakable decisions which are irreconcilable with the conclusion below. In the *Rowan* and *Sun Properties* cases the Fifth Circuit did more than criticize. It squarely held that an otherwise genuine corporate indebtedness cannot be treated as invested capital merely because there is a substantial spread between debt and stock, and the debt is owned by individuals in the same proportion as they own the stock. (Pet. 16-19.) Here, however, the courts below have done precisely what the Fifth Circuit has plainly disapproved.

2. The respondent attributes to the Fifth Circuit something which that court did not hold. According to the respondent, the Fifth Circuit "specifically agrees with other courts that where there are other factors to show that the noteholder interest in a corporation is a proprietary one the ratio of debt to equity capital is one of the relevant factors to be considered." (Resp. 7.) It is hard to say how the respondent derived this analysis from the *Rowan* and *Sun Properties* cases. While in both cases the Fifth Circuit carefully specified various factors which indicate a contribution to capital, the debt-equity ratio was not included among them. See *Rowan* v. *United States*, *supra*, at 55; *Sun Properties* v. *United States*,

[1] The respondent has not attempted to rebut the petitioners' assertion of conflict with this Court's opinion in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946), and decisions rendered by the Second, Seventh, and Ninth Circuits. (Pet. 19-20.)

supra, at 175-176. Of course, the omission is not surprising, since the Fifth Circuit held that the debt-equity ratio provides no reason for treating a corporate obligation as an investment in stock. See also *John Kelley Co.* v. *Commissioner*, *supra*, where this Court regarded the debt-equity ratio as wholly immaterial, though the obligation was hybrid in nature. (Pet. 14-16.) Moreover, for present purposes the respondent's reading of the Fifth Circuit's opinions is no less irrelevant than erroneous. For here, as in those two cases, there were no "other factors to show that the noteholder interest" in the Corporation was "a proprietary one." The only factor isolated below as the basis for decision was the spread between indebtedness and stock held in the same proportions. But these are the very "circumstances" which the Fifth Circuit has emphatically rejected as a legal excuse for treating an indebtedness as stock. To borrow the language of the Fifth Circuit, "There being no evidentiary fact shown on the trial that tends to prove" the notes "were other than debts, the trial court could only find that this is what they were." *Rowan* v. *United States*, *supra*, at 56.

3. As evidence that no conflict exists, the respondent strangely cites *Camp Wolters Enterprises* v. *Commissioner*, 230 F. 2d 555, 559 (5th Cir. 1956), *cert. denied*, 352 U.S. 826 (1956). (Resp. 7.) That case, however, has nothing to do with the present problem. The question there was not whether the respondent could treat notes as if they were stock because of the debt-equity ratio. The question, rather, was whether purchase money notes, which were concededly an indebtedness, qualified as "securities" within section 112(b)(5) of the 1939 Code. Compare *Pinellas Ice Co.*

v. *Commissioner*, 287 U.S. 462 (1933); *Bazley* v. *Commissioner*, 331 U.S. 737 (1947), with *Helvering* v. *Watts*, 296 U.S. 387 (1935). Section 112(b)(5) expressly distinguishes between "stock" and "securities." It is hornbook tax law that the word "securities" is used "in contrast to the word 'stock.'" "Securities" refers to certain kinds of corporate indebtedness—not to equity capital. *Commissioner* v. *Neustadt's Trust*, 131 F. 2d 528, 529 (2d Cir. 1942). See also *Lloyd-Smith* v. *Commissioner*, 116 F. 2d 642, 643-644 (2d Cir. 1941); *Camp Wolters Enterprises, Inc.*, 22 T.C. 737, 750 (1954); *John W. Harrison*, 24 T.C. 46, 51 (1955), *aff'd*, 235 F. 2d 587 (8th Cir. 1956), *cert. denied*, 352 U.S. 952 (1956); Griswold, *"Securities" and "Continuity of Interest,"* 58 Harv. L. Rev. 705 (1945). And a payment on "securities" is not a dividend.[2]

4. The respondent seeks to avoid certiorari by converting a significant question of law into a mere factual dispute undeserving of further review. "Contrary to the statements in the petition," the respondent asserts, "the courts below did not base their decisions solely on the ratio of indebtedness to equity capital, but considered all of the circumstances." (Resp. 6.) Here, too, the respondent has gone far afield in search of an argument.

As the respondent himself states, the facts are not in dispute. (Resp. 5.) The respondent readily agrees that the petitioners transferred assets to the Corporation for "its promissory notes, totalling $582,773.54;" that "the notes" were issued to the petitioners; and

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[2] A question involving "securities" will be reached here if this Court reverses the decision below. (Pet. 32, n. 21.)

that the Corporation made "payments" on "the notes." (Resp. 3.) And so the issue here is not one of reappraising the historical facts amid the details of evidence. The sole problem presented to this Court is the proper "interpretation of the legal significance" of the historical facts. *Brown* v. *Allen*, 344 U.S. 443, 507 (1953). See also *United States* v. *Felin & Co.*, 334 U.S. 624, 639 (1948). A so-called question of fact "does not cover a conclusion drawn from uncontroverted happenings" where the conclusion incorporates legal criteria of judgment. *Baumgartner* v. *United States*, 322 U.S. 665, 670-671 (1944); *Watts* v. *Indiana*, 338 U.S. 49, 51 (1949). In short, the only question is whether "the wrong standards for judgment have been applied" below to undisputed facts (*Commissioner* v. *Culbertson*, 337 U.S. 733, 749 (1949)), and such a question is inevitably an issue of law. *Powers* v. *Commissioner*, 312 U.S. 259, 260 (1941).[3] Hence in similar and related cases, where the respondent sought to treat a plain-spoken indebtedness as equity capital, the Courts of Appeals have not hesitated to reverse the trial courts because their conclusion derived from an erroneous legal criterion. See, *e.g.*, *Rowan* v. *United States*, *supra*; *Sun Properties* v. *United States*, *supra*; *Kraft Foods*

[3] See also *Commissioner* v. *Lo Bue*, 351 U.S. 243 (1956). The question there was whether an employee realized income by exercising options to purchase stock in his corporate employer. The Tax Court held that no income was realized because the options were granted in order to give him "a proprietary interest in the corporation, and not as compensation for services." The Third Circuit affirmed on the ground that the Tax Court's determination resolved a factual issue and was not "clearly erroneous." *Id.* at 245-246. This Court reversed because the finding reflected an erroneous legal standard. *Id.* at 247.

Company v. *Commissioner*, 232 F. 2d 118 (2d Cir. 1956); *Miller's Estate* v. *Commissioner*, 239 F. 2d 729 (9th Cir. 1956). If no question of law is here involved, then the Courts of Appeals have been remarkably remiss in exercising their function.

Here, clearly, the decision below derived from an erroneously conceived criterion of tax law — that promissory notes held by shareholders are to be treated as stock if the amount of the notes is substantially more than the equity capital. Though the respondent refers to "all of the circumstances" on which the courts below allegedly relied, no other "circumstances," apart from the debt-equity ratio, are to be found.[1] Nor can the respondent skilfully eliminate an issue of law by conveniently dubbing it a question of fact. See especially *Sun Properties* v. *United States*, *supra*, at 173.

We are merely echoing what the Tax Court itself indicated in *Ainslie Perrault*, 25 T.C. 439 (1955), on the very day that it rendered its decision here. In the *Perrault* case two brothers were engaged in business as equal partners. They organized a new corporation

[1] In this connection the respondent cites in behalf of himself a number of irrelevant decisions. (Resp. 5-7.) Except for *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957), they all involved cases where the legal nature of the obligation was ambiguous or hybrid. Hence the courts naturally weighed the various factors which pointed in both directions and observed the content of the obligation. The *Gooding* decision turned on a specific finding that the taxpayers did not subjectively intend to create an indebtedness — a finding which was supported by the behavior of the taxpayers. That decision does not remotely approve or involve a refusal to recognize a corporate indebtedness because of the debt-equity ratio.

in which they were equal stockholders and to which they promptly sold most of the partnership assets. Except for the debt-equity ratios, this case and the *Perrault* case are indistinguishable. In both the sale was made to a corporation in which the sellers simultaneously acquired the stock. In both the sales price reflected a fair valuation of the transferred assets. In both the price was payable in installments. And in both each seller held the same portion of the stock and the indebtedness. Yet in the *Perrault* case the Tax Court held that the installment payments were taxable as the proceeds of a sale, while here it held that the payments were taxable as dividends on stock. And the only basis for the difference in result was the difference in the debt-equity ratio.

5. As a further argument against certiorari the respondent resorts to the familiar rhetoric of "substance" and "form." (Resp. 5, 8.) As Judge Learned Hand has acutely remarked, "such vague alternatives as 'form' and 'substance'" are simply "anodynes for the pains of reasoning." *Commissioner* v. *Sansome*, 60 F. 2d 931, 933 (2d Cir. 1932), *cert. denied*, 287 U.S. 667 (1932). If they fail to be loud, at best they merely leave us on the threshold of the statutory problem to be solved. Compare *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950), with *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945). At any rate, as Judge Learned Hand has also stated, a transaction has ample "substance" if it is intended to be "in fact what it appears to be in form." In other words, a transaction does not lack "substance" unless it is designed to be meaningless or sham. *Chisholm* v. *Commissioner*, 79 F. 2d 14, 15 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1935). See also *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935).

Obviously, there is no problem of sham here; and the respondent's talk of "substance" and "form" is but another irrelevancy improvised for the occasion. The Tax Court clearly found that the petitioners sold their assets to the Corporation; that the assets were sold for notes; that the notes evidenced the Corporation's agreement to pay for the assets; and that the Corporation regularly paid principal and interest on the notes. (Pet. App. 13a-16a, 19a.) In the Tax Court's unambiguous words, "the five partners transferred their partnership property to a corporation solely in exchange for notes totaling $582,773.54." (Pet. App. 23a.) According to the Tax Court's findings, then, the petitioners received the notes as sellers and enforced the notes as creditors. Throughout the findings there is not the slightest suggestion that the notes were sham.[7] Otherwise, of course, the courts below would have found it unnecessary to appraise the tax consequences of the notes and payments in the light of the debt-equity ratio. As in the *Sun Properties* case, the transfer of the assets for notes "was a sale in fact as well as in form." 220 F. 2d at 173. An indebtedness was truly intended and truly created. The respondent has failed to cite a single case, apart from the decision below, where an unambiguous corporate indebtedness, held in the same proportion as the stock, was treated as equity capital merely because of the debt-equity ratio.

The crux of the matter is clear. What the respondent has done is to disregard the substance of the legal rights and obligations truly expressed by the notes. He has simply made believe, under cover of the debt-

[7] Nor is there the slightest suggestion of any motive to avoid tax.

equity ratio, that the indebtedness is stock, and proceeded to conjure tax consequences out of an imaginary transaction. By the same token, the significant question remains whether the respondent may impose real tax liabilities on the basis of his philosophy of "as if." His loose observations on "form" and "substance" do not obscure the need for this Court's resolution of that question. As Mr. Justice Brandeis pointed out, tax cases are not decided in response to transactions which never occurred. See *Founders General Corp.* v. *Hoey*, 300 U.S. 268, 275 (1937).

6. Finally, the petitions for certiorari emphasize that the decision below envelops important areas of tax law in grave doubt and disorder. Both the 1939 Code and the 1954 Code are equally affected. (Pet. 20-27.) The respondent does not try to deny the unsettling effects of the decision.[6] Instead he simply suggests that the resulting confusion is a normal aspect of an intelligent system of tax administration. It seems enough to say that when the respondent loses below and applies for certiorari, he is usually more

[6] Similarly, the respondent does not deny that he has taken conflicting views in regard to the alleged principle of debt-equity ratio. Evidently the controlling consideration has been what will produce the highest tax in the immediate case. (Pet. 26-27.) Aside, perhaps, from a conflict among the Courts of Appeals, there is no better occasion for certiorari in tax litigation than "the resultant confusion", in administration due to "inconsistent positions" by the respondent. Cf. *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, 42 (1939).

sensitive to the basic requirements of a fair and workable tax system.

Respectfully submitted,

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